DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/1/06**	Bill No:	**AB 1933**
Tax:	**Sales and Use, Special, Property**	Author:	**Coto**
Related Bills:			

BILL SUMMARY

This bill would modify the provisions related to the annual tax expenditures report prepared by the Department of Finance (DOF) to require the Legislature, on July 1, 2008, and on each July 1 of each 10^{th} year thereafter, to review all of the tax expenditures and repeal those tax expenditures that do not advance or serve a public purpose or policy, as specified.

ANALYSIS

Current Law

Since 1971, pursuant to Section 13305 of the Government Code, the Department of Finance has been required to provide a tax expenditure report to the Legislature. Chapter 1762, Statutes of 1971, required that the report be submitted to the Legislature once every two years. Chapter 268, Statutes of 1984, increased the reporting frequency to once a year. The required report includes each of the following:

- A comprehensive list of tax expenditures.
- Additional detail on individual categories of tax expenditures.
- Historical information on the enactment and repeal of tax expenditures.

Proposed Law

This bill would amend Section 13305 of, and add Section 13305.5 to, the Government Code to do the following:

1) Define "tax expenditure" as a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by state law.
2) By July 1, 2008, and by July 1 of each 10^{th} year thereafter, require the Legislature to review all of the tax expenditures that have been existence since January 1, 2007, and require the Legislature to repeal those tax expenditures that do not do either of the following:
   - Advance a public purpose or policy;
   - Serve a public purpose or policy.

   This provision does not apply to tax expenditures related to food, prescription drugs, health services, or residential rent.
3) Effective January 1, 2007, provide that any legislative measure creating a tax expenditure will meet both of the following requirements:

- The measure may only provide for a single tax expenditure;
- The measure will include a factual statement of the public purpose or policy that is to be advanced or served by the expenditure.

Background

There have been several bills introduced during the last few years related to tax expenditure reports. These include:

AB 168 (Ridley-Thomas, 2005), would have required: (1) the Board and the Franchise Tax Board (FTB) to each provide to the Legislature, the DOF and the Legislative Analyst Office (LAO), a report, based on a static revenue analysis, of the estimated revenue losses attributable to each tax expenditure, to the extent feasible, that produced a revenue loss in excess of $25 million in the prior fiscal year; (2) the DOF to provide, biennially, to the Legislature and the LAO, a report, based on a dynamic revenue analysis, of the estimated revenue losses attributable to tax expenditures that produced revenue losses in excess of $25 million, as specified; (3) the LAO to review the reports and make recommendations to the Legislature as to which tax expenditures should be modified or repealed.

AB 168 was vetoed by Governor Schwarzenegger and the veto message states:

> "The Department of Finance and the Legislative Analysts Office currently have broad authority to review and report tax expenditures to the Legislature. This bills restatement of the existing tax reporting requirements is redundant and unnecessary. "

AB 735 (Arambula, 2005), would have: (1) required the LAO to establish a process to review all tax exceptions, and submit a report to the Legislature by December 31, 2006; (2) required the LAO to review and analyze any relevant reports prepared by the DOF, and request assistance from the Board and the FTB in order to make the report as comprehensive as possible; and (3) directed the Assembly and Senate Revenue and Taxation Committees to review the report submitted by the LAO and authorize them to select a group of tax exceptions for deletion or modification, reporting their recommendations to the fiscal committees for consideration during the budget process. This bill was never heard by a committee.

SB 577 (Figueroa, 2005), would have, among other things, required the DOF, in consultation with the Board and the FTB, to report to the Legislature by January 1, 2008, on the effectiveness of "tax expenditures," as defined. This provision was amended out of the bill.

AB 2106 (Ridley-Thomas, 2004), would have, among other things, required the DOF, in conjunction with the Governor's Budget, to submit to the Legislature a report of tax expenditures currently in effect. The bill would have specified that, among other things, based on information provided by the Board to the extent feasible, the report include the number of tax returns or taxpayers affected by any sales or use tax expenditure, the distribution of that expenditure, and the size and type of business or industry to which that expenditure is made available.

AB 2106 was vetoed by Governor Schwarzenegger and the veto message states:

> "Under existing law, the Department of Finance already is required to provide an annual tax expenditure report to the Legislature containing specific

information. This bill changes the type of information that is provided in the annual report. However, some of the information that Department of Finance would be required to report is not available. For example, the original intent of a given tax expenditure is often not clearly defined in the enabling statute. In addition, the number and income distribution of taxpayers benefiting from sales tax exemptions would not be known because this information is not required to be reported by retailers when filing their tax returns. Furthermore, some of the information might not be available for reporting to the Legislature because of existing confidentiality requirements."

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the American Federation of State, County, Municipal Employees. According to the sponsor, while the annual tax expenditure report prepared by the DOF provides information about tax expenditures, there needs to be a periodic review of those tax expenditures to determine whether they are continuing to serve the public.

2. **The Board does not have specific data on tax expenditures.** This bill would require the Legislature, by July 1, 2008, and by each July 1 of each 10th year thereafter, to review all tax expenditures and to repeal those tax expenditures that no longer advance or serve a public purpose. This bill does not specifically require the Board to provide data on tax expenditures. However, an explanation regarding the information available on the tax returns, including the differences between tax return data captured for state income tax purposes versus tax return data captured for sales and use tax purposes, might be useful.

   In general, revenue estimates and expenditure data for the Personal Income Tax and Corporation Tax Laws are easier to quantify than they are for the Sales and Use Tax Law. Personal income and corporation tax returns contain significant detail regarding different sources of income and types of exemptions, exclusions, deductions, and credits claimed. Thus, tax return data are often available when estimating the fiscal impact of various income and corporate tax expenditure programs. In contrast, returns filed by taxpayers under the Sales and Use Tax Law (a copy of which is attached) contain little specific information regarding tax expenditures).

   As shown on the attached sales and use tax return, some of the more common tax expenditures allowed under the Sales and Use Tax Law are separately identified on the return itself for purposes of allowing taxpayers to claim the deduction. These include deductions for, among others, sales of food products, sales to the U.S. Government, sales in interstate or foreign commerce, and nontaxable labor (note, the law contains numerous other tax exemptions and exclusions not separately identified on the return).

   However, instead of actually itemizing these deductions, many taxpayers simply report their taxable sales, netting out any exempt sales. Any attempt to capture the amount of exempt transactions would require a much more extensive tax return and would require a very large effort from taxpayers to detail these transactions. However, even if the Board were to require retailers to report on each tax expenditure, we would still not have any data regarding the consumers that are actually benefiting from these exemptions.

Consequently, return information does not capture specific data on the myriad of tax exemptions and exclusions provided under the law, and is not a reliable source to use in making estimates of revenue losses attributable to those exemptions and exclusions. As such, the Board generally relies on independent data sources when estimating the revenue impacts of various sales tax expenditure programs.

The exception to this is for partial exemptions. The Board currently requires the taxpayer to specify the amount of those exemptions that apply to only a portion of the combined state and local sales and use tax. There are currently five such exemptions in effect:

- Teleproduction Equipment
- Farm Equipment
- Diesel Fuel Used in Farming and Food Processing
- Timber Harvesting Equipment and Machinery
- Racehorse Breeding Stock

Sales of these commodities are exempt from the *state* sales and use tax. Local and special district sales and use taxes continue to apply. In order for a taxpayer to claim these exemptions, they must report the amount of the transactions that are subject to the partial exemption. For these exemptions, the Board knows how much is being claimed as well as how many retailers are claiming the exemption. However, what the Board does not know is how many consumers are benefiting from these exemptions and the amount of the benefit to each consumer.

Without some kind of an incentive, it would be difficult to require taxpayers to furnish the Board with information regarding tax exemptions. For the partial tax exemptions, the Board gets this information because the taxpayers cannot claim the exemption without providing the information.

In summary, tracking tax exemptions is only feasible if the taxpayer has an incentive to report those exemptions. For the vast majority of sales and use tax exemptions, this incentive does not exist.

3. **The Board's Publication 61, *Sales and Use Taxes: Exemptions and Exclusions*, provides a detailed listing of various exemptions and exclusions from the sales and use tax.** The publication has two sections: first by category and second by alphabetical reference. The listings provide a brief general description of the exemption or exclusion, including the statutory authority. The listing by category also provides an estimate of the revenue loss of the exemption or exclusion, if available. As previously stated (see Comment 2), a revenue loss of a particular tax expenditure is not always possible to quantify.

4. **Special Taxes expenditures.** The Board administers the following special tax and fee programs: Aircraft Jet Fuel Tax, Alcoholic Beverage Tax, California Tire Fee, Childhood Lead Poisoning Prevention Fee, Cigarette and Tobacco Products Tax, Diesel Fuel Tax, Electronic Waste Recycling Fee, Emergency Telephone Users Surcharge, Energy Resources Surcharge, Hazardous Substances Tax, Insurance Tax, Integrated Waste Management Fee, Interstate User Tax, Marine Invasive Species Fee, Motor Vehicle Fuel Tax, Natural Gas Surcharge, Occupational Lead Poisoning Prevention Fee, Oil Spill Response, Prevention, and Administration Fees, Underground Storage Tank Maintenance Fee, Use Fuel Tax and Water Rights Fee.

Some of the major tax exemptions are: Distilled spirits exported or sold to common carriers, Distilled spirits sold to armed forces, Beer and wine exported from California, Exempt distributions of cigarettes sold and shipped in interstate or foreign commerce, Exempt distributions of cigarettes sold to interstate foreign passenger common carriers, Exempt distributions of cigarettes sold to U.S. Military exchanges, commissaries, ship stores & U.S. Veterans Administration, Motor vehicle and diesel fuel exported, Fuel sold to the United States Government, Diesel and use fuel for use on farms, Diesel and use fuel for exempt bus operators, Diesel and use fuel for off-highway vehicle operations, Aircraft jet fuel sold to the United States Armed Forces, Aircraft jet fuel sold to air common carriers, and Aircraft jet fuel exported.

As shown above, some of the more common special tax expenditures are separately identified on the return. However, like sales and use tax expenditures, many taxpayers net out exempt sales or combine exempt sales on one line of the return. For these reasons, the return does not capture all data on the various exemptions. Consequently, the Board generally relies on independent data sources when estimating the revenue impacts of various special tax expenditure programs. It should be noted that for some of the special tax exemptions, the taxpayers reporting and filing returns, might not be the one benefiting from the exemption.

5. **Property Taxes. Property taxes are largely administered by county assessors in the state's 58 counties. The Board provides oversight to the 58 county assessors and monitors the adequacy of their assessment practices.**

The state Constitution provides for a variety of full and partial exemptions from the property tax. Some of the exemptions are required by the Constitution. Others are not specifically required but the Constitution provides that the Legislature may, by statute, provide for the exemption. This bill defines "tax expenditures" to mean a credit, deduction, exclusion, exemption, or any other tax benefit as provided by state law. Would the exemptions required by the state Constitution be considered "tax expenditures" under the provisions of this bill[1]?

There are over 100 exemptions and exclusions from property tax. An exclusion, for property tax purposes, is the denial of reassessment. For real property, some of the major exemptions are: Disabled Veterans Exemption, Homeowners' Exemption[2], and Welfare Exemption. For real property, some of the major exclusions are: Disabled New Construction Exclusion, Disaster Relief Change in Ownership and New Construction Exclusions, Interspousal Change in Ownership Exclusion, Over 55 and Disabled Homeowners' Change in Ownership Exclusion, Parent-Child and Grandparent-Grandchild Change in Ownership Exclusion, and Seismic Safety New Construction Exclusion.

Data on some of the exemptions are maintained by the county assessors. For the exclusions, in general, the data is not maintained. In the case where data is not maintained, the Board would estimate the revenue impact using independent data sources, to the extent feasible. However, in some cases, it is not possible to quantify the revenue loss of a tax expenditure because the data is not available.

[1] One of the largest tax expenditures is the Proposition 13 revenue loss, and the Proposition 8 decline in value.
[2] The Homeowners' Exemption is a budget expenditure. The counties are reimbursed by the state. It is shown in Schedule 9 under Tax Relief of the Budget Act.

In addition, there are preferential tax treatments for real property. Would preferential tax treatments be considered tax expenditures? One of the major preferential tax treatments is the Williamson Act. The Williamson Act program provides a tax incentive for the conservation of farmlands, open space, and wildlife habitat lands by reducing the property tax on land that is restricted for these purposes. For real property qualifying for special treatment under the Williamson Act[3], data is available to develop an estimated revenue loss.

For personal property, some of the major exemptions are: Aircraft Being Repaired, Aircraft of Historical Significance, Business Inventories[4], Cargo Containers Used in Ocean Commerce, Financial Assets, Household Furnishings and Personal Effects, Vessels, Documented Vessels, and Vessels Under Construction. For the personal property tax exemptions, data is maintained on some of the exemptions. For those exemptions where data is not maintained, a revenue estimate would be developed using independent data sources, to the extent feasible, unless such data was not available. An example of a personal property tax expenditure for which a revenue loss could not be quantified would be Financial Assets.

COST ESTIMATE

This bill modifies provisions related to the annual tax expenditures report prepared by the DOF to require the Legislature, on July 1, 2008, and on each July 1 of each 10th year thereafter, to review all of the tax expenditures and repeal those tax expenditures that no longer advance or serve a public purpose. Unless the Board is asked to assist in providing data on tax exemptions, there is no impact to the Board's administrative costs.

REVENUE ESTIMATE

To the extent that future reviews and evaluations result in the identification and termination of ineffective or inappropriate tax expenditures, enactment of this measure could result in unknown additional revenues.

ATTACHMENT

http://www.boe.ca.gov/pdf/boe401a2.pdf

bat Docu

Analysis prepared by:	Debra Waltz	916-324-1890	03/13/06
Contact:	Margaret S. Shedd	916-322-2376	

ls 1933-1dw.doc

[3] The Williamson Act is a budget expenditure. The counties are reimbursed by the state. It is shown in Schedule 9 under Tax Relief in the Budget Act.

[4] Business Inventories are 100 percent exempt starting 1980-81. This exemption is often overlooked because the owner does not have to file a claim.